

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 96-0515 RST
Gross Income Tax
For The Periods: 1989 Through 1994**

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ISSUES

I. Gross Income Tax B High Rate v. Low Rate

Authority: IC 6-2.1-2-1; IC 6-2.5-3-2; IC 6-2.1-2-3; Information Bulletin No. 2

The taxpayer protests that its receipts from software upgrade contracts were taxed at the high rate for gross income tax.

II. Tax Administration – Imposition of Negligence Penalty

Authority: I.C. 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer is a producer of computer software for sale to the public with software support as a large part of the taxpayer=s sales. The taxpayer=s revenue at issue consists of revenue from the sale of software maintenance contracts and revenue from consulting and education services. The taxpayer treated these sales as sales of tangible personal property as related to gross income tax rates.

A sales and use tax audit was performed concurrently with the gross income audit. The taxpayer was collecting sales tax on most of its software maintenance contract invoices and the auditor assessed sales tax on the remainder. The auditor also assessed the higher gross income tax rate for service contracts on the software maintenance contracts and the consulting and education service contracts. While the taxpayer concedes that

the higher gross income tax rate for services would apply to the consulting and education service contracts, the taxpayer protests that in spite of the Department's recognition that the software maintenance contracts were tangible personal property in the sales and use audit, the receipts of the contracts were taxed as a service at the high rate.

I. Gross Income Tax B High Rate v. Low Rate

DISCUSSION

At issue is whether the taxpayer is acting as a retail merchant or a service provider in the context of its software maintenance contracts. The taxpayer states that it is acting as a retail merchant, therefore their receipts are subject to the "low" rate of Indiana Gross Income taxation.

IC 6-2.1-2-3 sets the rates of tax for gross income:

The receipt of gross income from transactions described in Section 4 of this chapter is subject to a tax rate of three-tenths of one percent (0.3%).

The receipt of gross income from transactions described in Section 5 of this chapter is subject to a tax rate of one and two-tenths percent (1.2%).

The transactions contained in Section 4 of IC 6-2.1-2 include selling at retail and are taxed at the "low" rate of three-tenths of one percent (.3%). Transactions found in Section 5 include services and are taxed at the "high" rate of one and two-tenths percent (1.2%).

IC 6-2.1-2-1(b)(1) defines selling at retail as a "A transaction in which a retail merchant in the ordinary course of his regularly conducted business transfers the ownership of tangible personal property to another, conditionally or otherwise, for a consideration".

At a minimum, maintenance contract customers receive one major update per year. The taxpayer treats these sales as tangible personal property per Information Bulletin No. 2, which states:

A computer software company sells a taxable software package to a customer for \$2,000. The customer also purchases a maintenance agreement from the company. The customer did not have to buy the maintenance agreement. The agreement entitles the customer to up to twenty hours of programmer help to deal with any problems

the customer might have in using the software package. The maintenance agreement is an optional maintenance agreement and is not subject to sales tax.

Same facts as in Example 4, but the maintenance agreement also entitles the customer to four program updates per year. The program updates are available to all of the company=s customers who purchased the software package. The maintenance is subject to sales tax because it is a certainty that tangible personal property, the updates, will be given to the customer under the terms of the maintenance agreement.

Sales tax was collected in the sales of the software support contract. The taxpayer is acting as a retail merchant in its sales of the software support contracts. As indicated in the bulletin, it is possible for some of the maintenance contracts to be treated as service contracts, but to the extent that taxpayer=s sales, as verified in the sales and use tax audit, are having the sales tax assessed they are subject to the Allow@ rate of income tax provided in IC 6-2.1-2-3(a).

FINDING

The taxpayer=s protest is sustained. The sales with sales tax reported and the sales tax assessed are subject to the Allow@ rate of gross income tax.

II. Tax Administration – Imposition of Negligence Penalty

DISCUSSION

Indiana Code 6-8.1-10-2.1 (d) states, in part, that if, Athe deficiency determined by the Department was due to reasonable cause and not willful neglect, the Department shall waive the penalty.

Regulation 45 IAC 15-11-2(b) also states, in part:

- (b) Negligence on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer.

The auditor noted that the taxpayer filed late for three of the audit years; additionally the taxpayer did not protest the auditor=s findings related to gross income tax on consulting and educational services. Both timely filings and the application of the correct gross income rates for the aforementioned services constitute a failure to use reasonable care, caution, or diligence by the taxpayer. Consequently, the negligence penalty will apply to this assessment.

FINDING

The taxpayer=s protest is denied.

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